

Foundations of Economics

Topic 2

Learning Objectives

- Define the two main branches of economics: micro- and macroeconomics
- Distinguish between fact-based and opinion-based statements/recommendations
- Describe the framework that economists use to model human behavior

Economics

Recall:

- Economics is the Social Science that studies how people make decisions in the face of scarcity and the resulting impact of such decisions on both society as a whole and on the individual therein.
- This implies:
 - “Micro-level”: The individual within an economy
 - “Macro-level”: The economy as a whole

Microeconomics

- Is the branch of economics which studies how individual decision-makers behave and interact with each other.
- Often focuses on how households and firms behave and interact with each other in markets.
- For example:
 - How do households allocate its scarce resources among its various members, taking into account each member's abilities, effort, and desires?
 - Who cooks dinner? Who does laundry? Who goes grocery shopping? What is consumed?

Macroeconomics

- Is the branch of economics which studies the functioning and performance of a society's economy as a whole.
- Often focuses on levels and changes in aggregate measures.
- For example
 - How can problems in the housing market spread to the rest of the economy?
 - Why are so many countries poor? What policies might help them grow out of poverty?
 - What is a trade deficit? How does it affect a country's well-being?

Positive and Normative Statements

- Positive statement or statement of “fact”
 - Aims to describe how the world actually is or actually functions
 - Observations on or predictions about outcomes, without judging of their desirability
 - For example:
Of all U.S. Presidents, Ronald Reagan was the oldest to ever hold office.
- Normative statement or statement of “opinion”
 - Aims to assess the desirability of how the world is or functions
 - Statements explicitly or implicitly supported by priorities, goals, and value judgements of the person making the statement
 - For example:
Of all U.S. Presidents, Ronald Reagan was the greatest.

Now you try! Normative or Positive?

- All students should study at least five hours a day.
- The average student drinks five cups of coffee every week.
- If demand goes up, price goes up too.
- Tuitions fees should be limited to \$500 per semester.
- Economics is a fascinating subject.
- Players in the national football league make, on average, more money than players in the national chess league.
- After World War II the female labor force participation rate increased dramatically.

Positive and Normative Statements – Ctd.

- Disagreement among economists
 - Over a positive statement: because not enough data and evidence has yet been gathered to prove the statement either true or false.
 - Over a normative statement: because of different opinions, priorities, or value judgments.

The Cost-Benefit Principle

- Cost-Benefit Principle
 - An individual should undertake an activity if and only if the additional benefit of doing so is greater than or equal to the additional cost of doing so.
- Axioms
 - Rational decision making
 - Total benefits
 - Total costs
 - Total economic surplus

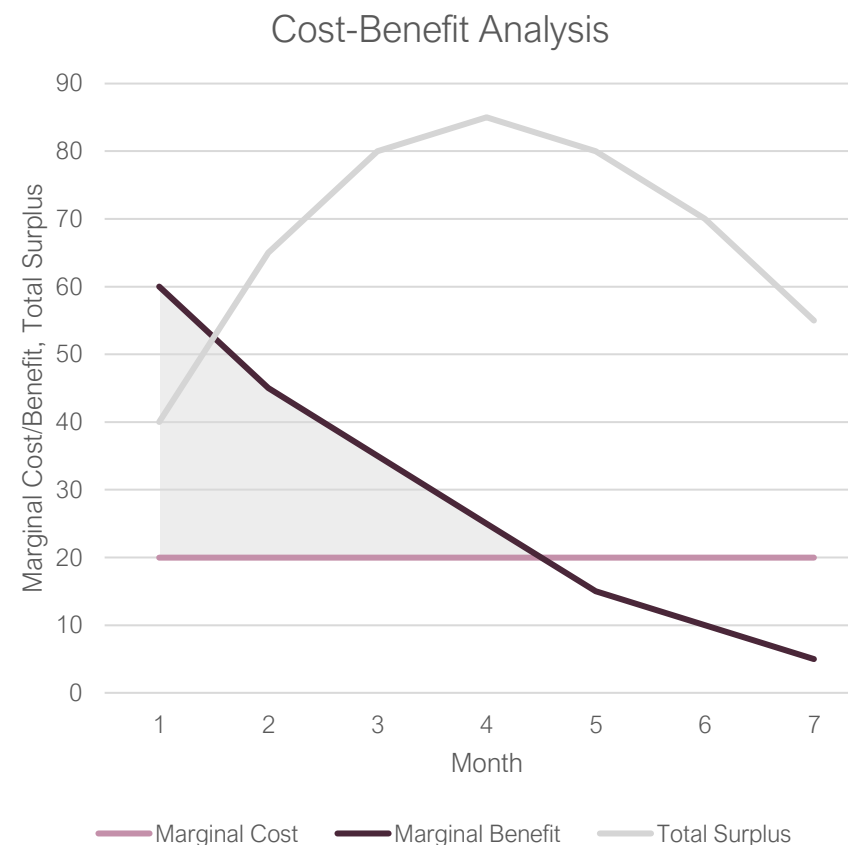
The Cost-Benefit Principle – Ctd.

- Cost-Benefit Analysis
 - Direct comparison of the marginal benefit of the activity to the marginal cost of the activity
- Marginal Benefit
 - The change in the value of total benefits as more of an activity is undertaken
 - **Diminishing returns**: the additional value from doing an activity declines as it is consumed more
- Marginal Cost
 - The change in the value of total cost as more of an activity is undertaken

The Cost-Benefit Principle – Ctd.

■ An Example

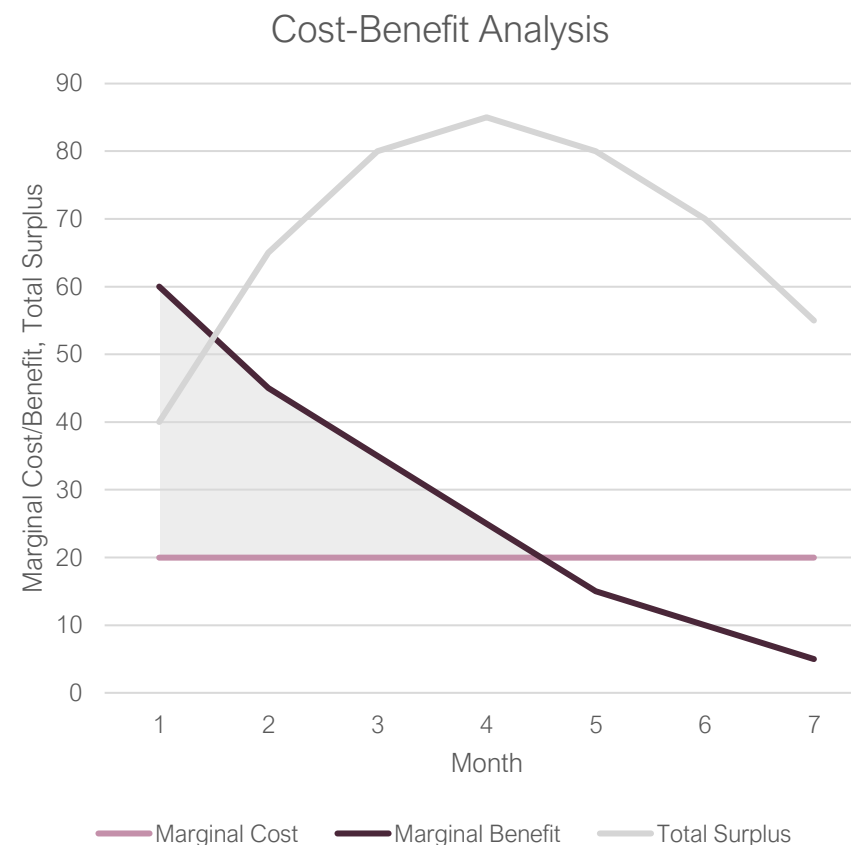
TV Months	Total Benefit	Total Cost	Marginal Benefit	Marginal Cost	Marginal Surplus	Total Surplus
0	0	0	-	-	-	-
1	60	20				
2	105	40				
3	140	60				
4	165	80				
5	180	100				
6	190	120				
7	195	140				



The Cost-Benefit Principle – Ctd.

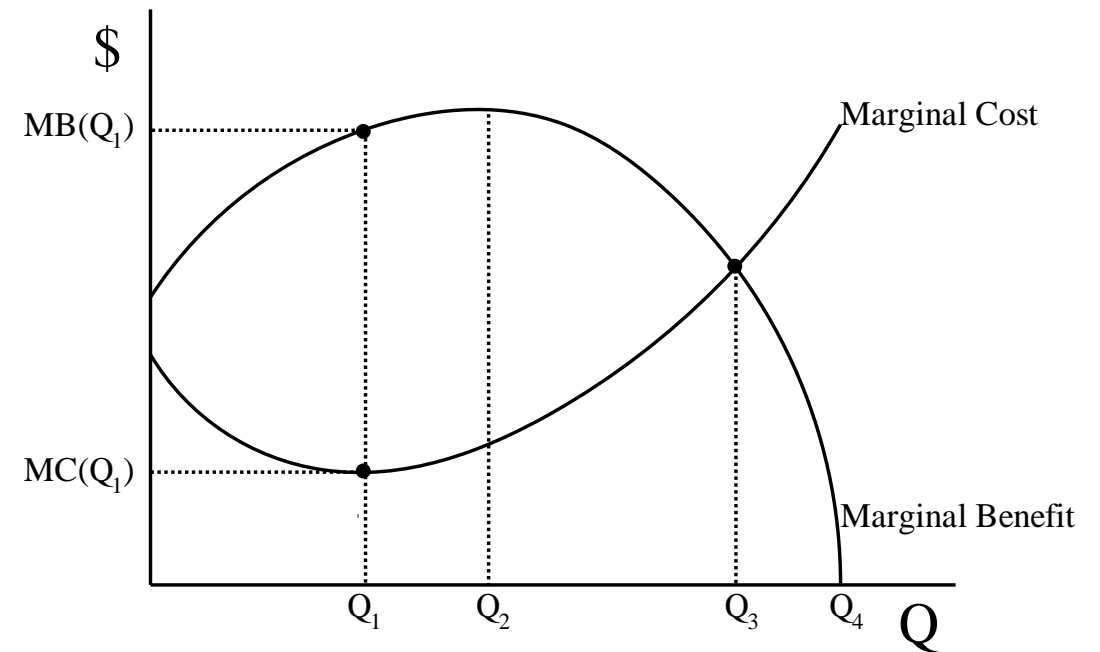
■ An Example

TV Months	Total Benefit	Total Cost	Marginal Benefit	Marginal Cost	Marginal Surplus	Total Surplus
0	0	0	-	-	-	-
1	60	20	60	20	40	40
2	105	40	45	20	25	65
3	140	60	35	20	15	80
4	165	80	25	20	5	85
5	180	100	15	20	-5	80
6	190	120	10	20	-10	70
7	195	140	5	20	-15	55



The Cost-Benefit Principle – Ctd.

- Cost-Benefit Analysis formalized/ Maximizing Economic Surplus
 - Minimize marginal cost
 - Maximize marginal benefit
 - Maximize the difference between marginal cost and marginal benefit



The Incentive Principle

- Incentive Principle
 - A rational person will consume more, if the marginal benefit of consuming an additional unit increases.
 - A rational person will consume less, if the marginal cost of consuming an additional unit increases.
 - Thus, as benefits or costs change, the behavior of a rational decision maker will likely change.
- Example:
 - The cost for attending college

Summary

- **Microeconomics** studies how individual decision-makers behave and interact with each other.
- **Macroeconomics** studies the functioning and performance of a society's economy as a whole.
- **Positive statements** aim to describe how the world actually is or actually functions.
- **Normative statements** aim to assess the desirability of how the world is or functions.
- **Cost-Benefit Analysis** is the direct comparison of the marginal benefit of the activity to the marginal cost of the activity.